

Appendix 2: Links with other work-streams

The energy sector is undergoing fundamental change. The regulatory and market arrangements will need to evolve to ensure change happens in a way that advances consumers' interests, while enabling them to benefit from innovation.

We have a programme of reform to meet the challenges of an evolving energy sector. We described this in our **Strategy for Regulating the Future Energy System**.¹

A key part of this is our partnership with government on the move to a Smart, Flexible Energy System.² In October 2018, we published an update which describes progress, priorities and new actions.³

Across our programme, our aim is to ensure a regulatory framework that drives innovation, supports the transformation to a low carbon energy system and delivers the sustainable, resilient, and affordable services that all consumers need. In relation to networks specifically:

- Through our RIIO price controls, we are ensuring that the Electricity System Operator (ESO) and network companies have the right incentives to develop, maintain and operate the networks while minimising costs to consumers. This includes ensuring they make full use of flexible alternatives to traditional reinforcement. The RIIO controls also need to make sure that network companies can recover efficiently incurred costs. The RIIO price control for electricity transmission will start in April 2021, and we have published our consultation on our sector methodology alongside this letter.⁴ The price control for electricity distribution will start in April 2023 and the programme for the access and forward looking charging review is aligned with this.
- In order to access that flexibility, it is also important that network users receive effective signals about how their behaviour can bring costs and benefits to the networks. This will be achieved through -
 - This review, focusing on how access and charging can send effective signals about the value that users who are able to be flexible can bring in terms of reducing future ("forward-looking") network costs.
 - Procurement of flexibility by the ESO and Distribution Network Operators (DNOs), where signals from effective access and forward-looking charging arrangements do not fully balance the system or manage network

¹ Strategy for Regulating the Future Energy System, Ofgem, 2017 https://www.ofgem.gov.uk/system/files/docs/2017/08/our_strategy_for_regulating_the_future_energy_system.pdf

² Smart, Flexible Energy System, Ofgem and government, 2017 <https://www.ofgem.gov.uk/publications-and-updates/smart-flexible-energy-system-call-evidence>

³ Upgrading our Energy System – Smart Systems and Flexibility Plan: Progress Update, Ofgem and government, 2018 <https://www.ofgem.gov.uk/publications-and-updates/upgrading-our-energy-system-smart-systems-and-flexibility-plan-progress-update>

⁴ RIIO-2 sector methodology consultation, Ofgem, 2018 <https://www.ofgem.gov.uk/publications-and-updates/riio-2-sector-methodology-consultation>

congestion. We are working to define the role of DNOs in this area better as they take on Distribution System Operator (DSO) roles. Our work involves engaging constructively with a range of energy system actors, industry initiatives and government. It includes considering how DNOs and the ESO need to coordinate their activities to ensure that procurement is efficient from a whole system perspective, and considering how different options for procurement platforms can support this in an efficient way.

- This review and the **Targeted Charging Review (TCR)** are reviews on changes to the way in which we recover the costs of the networks used to transport electricity to homes, public organisations and businesses. These costs are recovered through two types of charges: 'forward-looking charges' which send signals about how much costs will increase (or decrease) with network usage, and 'residual charges'⁵ which recover the remainder of the costs. The forward-looking charges are the focus of this review, and residual charges are the focus of the TCR. Residual charges are not intended to send price signals to users to change their behaviour. However, we consider the current residual charges are causing distortions to behaviour as some users seek to reduce their exposure to them, without reducing costs to consumers overall. We are consulting on proposed changes to reduce these distortions and improve the fairness of residual charging through our TCR. We are consulting on changing the design of residual charges to a fixed charge, and applying residual charges to final demand users only (residual charges are currently applied to generation and final demand users)⁶

Some key interactions between our work on access and forward-looking charges and wider Ofgem projects include:

- **RIIO-2 price control.** Access and charging reforms may change the scope of what is included in a given sector's price control. The change in scope as a result of reforms could reflect changes in the triggers for investment, the amount of investment expected, or in how investment costs are recovered. We will consider how this is best reflected in both RIIO-electricity transmission and electricity distribution arrangements and will coordinate with the network companies so that as far as possible any changes can be incorporated into their planning.

One important interaction is that any change to the connection charging boundary at distribution level would affect the allowed revenue which DNOs recover from all customers under the RIIO price control rather than directly from a connecting customer. We will only make such a change if we are satisfied that our overall package of reforms adequately protects the interests of consumers. If we decide to make a change in this area, we will aim to align it with the start of the RIIO electricity distribution price control, with any direction confirmed ahead of the sector methodology strategy decision so that DNOs can reflect this in their business plans.

It is also possible to design mechanisms and processes to account for changes during the price control period if required.

⁵ Residual charges can be a credit if forward looking charges exceed total costs or the cap on generation charges

⁶ Targeted Charging Review: Significant Code Review <https://www.ofgem.gov.uk/electricity/transmission-networks/charging/targeted-charging-review-significant-code-review>

- **Procurement of flexibility by the ESO and DNOs.** As discussed above, both access and charging arrangements and flexibility procurement are a means of accessing flexibility. Providing more accurate signals through access and charging can reduce the extent to which ESO and DNO procurement would be needed. We will consider the trade-offs between these approaches when weighing different options under the SCR. There will also be a need to consider how any curtailment of those with non-firm access (and any trading of curtailment obligations) is coordinated with wider flexibility procurement. This could include being handled through the same platform.
- **Targeted Charging Review.** This review and the Targeted Charging Review are covering different aspects of network charges (forward-looking charges and residual charges respectively). The changes we are considering in this review of access and forward looking charging arrangements may affect the amount of revenues to be recovered through residual charges. We have considered sensitivities for this in our draft impact assessment published alongside our consultation on TCR proposals.⁷ We will also produce an impact assessment for the access and forward looking charges proposals at a later stage.

There is also a link between some of the issues we identified in the TCR, particularly on examining the remaining embedded benefits, and our examination of forward-looking transmission and distribution charges. Both reviews seek to promote a level playing field between different sizes and types of users.

The overall complexity of the charging design and distributional impact on users will be influenced by both the changes in residual charge designs (consulted on through the TCR) and any changes in forward looking designs (from the Electricity Network Access Project). In this review, we will be mindful of these combined impacts.

We are also consulting on the timing of implementation of our proposals on residual charging, including potentially phasing in changes alongside our planned implementation dates for the access and forward looking charging review and for the RII02 price controls.

There are also important links to our work on retail markets:

- For small users, the smart meter rollout will enable the introduction of market-wide **Half-Hourly Settlement**⁸, which will expose suppliers or other intermediaries to improved price signals, incentivising them to help consumers unlock household flexibility. For example, this could be by developing new products and services to enable and encourage consumers to shift consumption to times of the day when electricity is cheaper to generate or transport. Half-Hourly Settlement would be a key enabler for a number of options we are considering here - suppliers or others could receive a combined set of signals in relation to their customers' usage, through cost-reflective charging arrangements

⁷ Targeted Charging Review: Minded to decision and draft impact assessment
<https://www.ofgem.gov.uk/publications-and-updates/targeted-charging-review-minded-decision-and-draft-impact-assessment>

⁸ We launched our Settlement Reform Significant Code Review in July 2017. Further information is here:
<https://www.ofgem.gov.uk/electricity/retail-market/market-review-and-reform/smarter-markets-programme/electricity-settlement>

and potential new access choices. These could reflect network constraints, potentially helping mitigate the need for new network capacity. Our proposed timescales reflect these links.

We are also planning to build our understanding of the consumer impacts of introducing electricity settlement reform, including the charging and access options which may follow, through a Call for Evidence which will consider both policy areas. We are aiming to gather stakeholder views and evidence on the extent to which some types of small users, notably domestic and small non-domestic customers, will be able to respond flexibly to unlock network and wider system savings. We will also seek to understand better what forms of support could help those who may be less able or willing to respond, and whether any additional protections may be needed.

- Under the current “supplier hub” **retail market model**, suppliers are an important intermediary, facing network charges on behalf of their customers.⁹ Our 2017 Call for Evidence considered whether alternatives to the current arrangements can enable consumers to benefit fully from the greater levels of innovation, digitalisation and competition made possible by the energy system transition.¹⁰ We concluded that the current retail market model may not be fit for purpose in the longer term, and there is a strong case for considering fundamental reforms. In line with this conclusion, the government and Ofgem have recently launched a **comprehensive joint review into the retail energy market** that will consider options for enabling new business models, while ensuring future consumers are protected.

The outcomes of this review could have implications for different options which we will consider in our SCR. For example, we may need to take into account how suppliers or other intermediaries may package network charging and access options into energy products and services for consumers in the future retail market. This could help enable response to (potentially complex) price signals and maximise consumer benefits.

- We have recently published our decision for the **default retail tariff cap** which will come into effect from 1 January 2019 and will protect default tariff and Standard Variable Tariff customers from being overcharged.¹¹ From 2020, each year we must publish a report including a recommendation whether the cap should be extended or not. The Secretary of State will then decide whether to extend the cap. If the cap is extended after each of our reviews, it will cease to have effect at the end of 2023.

If the temporary default retail tariff cap is still to be in place when the reforms from our SCR are due to be implemented, then we will need to consider how any

⁹ The current retail market model is often referred to as the ‘supplier hub’ because the supplier is positioned as the primary intermediary between consumers and the energy system. With this position comes a wide range of roles and responsibilities that have become entrenched in legal frameworks, licensing arrangements and industry rules. For consumers, it means they generally have to access the energy system through a licensed supplier, with these firms recovering costs arising through their energy use.

¹⁰ Future supply market arrangements – response to our call for evidence
<https://www.ofgem.gov.uk/publications-and-updates/future-supply-market-arrangements-response-our-call-evidence>

¹¹ Default tariff cap: decision overview (Nov 2018): <https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview>

access or charging options for households may interact with the price cap methodology and consider any action we may need to take.

- We are also engaging closely with the **Energy Data Taskforce**, which was launched jointly by the Department for Business, Energy and Industrial Strategy (BEIS) and Ofgem, announced in the Progress Update to the Smart Systems and Flexibility Plan.¹² The taskforce was established to undertake critical work to develop recommendations for how industry and the public sector can collectively facilitate greater competition, innovation and markets in the energy sector by improving data availability and transparency. It recognises the important role of robust data in the energy system transition.

Good quality data is an important enabler for options development in the access and forward-looking charging review. Given the work of the Taskforce to assess the current data landscape, identify gaps and determine recommendations, we will coordinate with this to identify where there are synergies with our work.

¹² The Data Taskforce terms of reference are available here: <https://www.gov.uk/government/groups/energy-data-taskforce>